

## Determinants analysis of earnings response coefficient: Empirical study in Indonesia

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### ABSTRACT

This study aims to analyze determinants of earnings response coefficient. Independent variables used in this research are company size, company's growth, profitability and financial leverage while the dependent variable is earnings response coefficient. The type of the research is quantitative research. The data used in this research is secondary data. The populations in this study are manufacturing companies listed in Indonesia Stock Exchange. The method of analysis that used in this research is multiple regressions. The results shows that company's growth has a positive effect on the earnings response coefficient. While the company size, profitability, financial leverage do not have any effect on the earnings response coefficient. This study indicates that high growth companies will give a good signal to investors.

### Introduction

Within investment activity, investor's going to need all the information available before proceeding into decision making phase. Beneficial information in decision making are relevant information. One of indicator from relevant information is there's reaction from investor while the information published (Arfan & Antasari, 2008). One of the most important factors in financial report is the declaration of information related to company's profit, which has probably attracted the highest rate of attention from investors (Moradi et al., 2010). However, company's profit has a drawback, it might be influenced by management assumption and probably manipulation. Therefore, information that are needed is not only about company's profit but also earnings response coefficient (Diantimala, 2008). Earnings Response Coefficient shows market reaction toward profit information published by a certain company and can be seen through stock price movement.

Research on earnings response coefficient (ERC) is useful in fundamental analysis by investors in valuation models to determine market reactions to a company's earnings information. ERC is influenced by many factors, based on research by Hasanzade et al. (2013) factors that influence ERC are earnings quality, financial leverage, growth opportunities, profitability, systematic risk. Of the many factors that have been investigated as factors that influence ERC, there are several factors that are inconsistent with the results, for example in the study of Diantimala (2008) explaining that company size has a significant effect on ERC while in Arfan and Antasari (2008) research explains that company size has no significant effect against ERC. Other factors that are inconsistent are financial leverage and profitability. Another study of the factors affecting ERC was conducted by Kusumawardhani and Nugroho (2010), in that study the independent variables used were social corporate responsibility, size, and profitability. The results of this study indicate that the three independent variables used indicate an influence on ERC both simultaneously and partially. But these results differ from studies conducted by Arfan and Antasari (2008) which show that profitability has no effect on ERC.

This is a further research that had been conducted by Arfan and Antasari (2008) before. This research uses three independent variable. The independent variables are company's size, company's growth and profitability. The independent variables show that company's size and profitability do not give any effect on earnings response coefficient. Thus, this research reexamine the three of independent variables and adds financial leverage as differentiation from the research before. Financial leverage adds in this research because financial leverage is the important signal by investor. Financial leverage is calculated by comparing debt with assets. When the ratio of financial leverage is high it can be interpreted that the company uses more sources of funds than debt

to obtain assets. So investors will think that the risk of a company in paying off its debt is greater than that of a company that uses more of its own capital as a source of funds in getting company assets.

The goal of this research is to analyze the determinant of Earnings Response Coefficient. The determinant of Earnings Response Coefficient (ERC) in this research are company size, company's growth, profitability, financial leverage. By knowing the factors that affect Earnings Response Coefficient from the information published by a company, investors will be able to predict the level stock price that is to come. The author chooses public company in manufacturing sector listed in Indonesia Stock Exchange as objects of research. So that it can represent company in Indonesia. Manufacturing company choose as objects of the research because the manufacturing sector is the biggest sector in Indonesian Stock Exchange.

## Literature Review

### Signaling Theory

According to Rahayu and Suaryana (2015) signaling theory explains that information is important element for investor and business society. It is because information give reports, notes or an overview of the past, present or future for company's going concern and how it impacts to the company.

Company size is signal that given by the company. A bigger company will earn more trust on running their business and pay off their debts compared to a small company. This statement suits with the research of Mashayekhi and Aghel (2016), the research explains that company size has significant relationship toward earnings response coefficient. Company's growth is a signal that published by the company through financial report. If the company has a promising growth, it will attract investor to invest their capital towards the company. Investor will assume that the company will grow bigger and give the investor a higher dividend annually. The statement appropriate with research that conducted by Hasanzade et al. (2013). The research explain that company's growth has significant relationship toward earnings response coefficient.

Profitability is also a signal given by the company. The company that successfully increased their profit indicates that the company has a good performance. In other words, a company with higher profit will attract investor, in that way, boosts earning response coefficient. This statement matches a research conducted by Kusumawardhani and Nugroho (2010). The research explain that profitability has a significant relationship toward earnings response coefficient. Another signal that issued by the company through financial report is financial leverage. When the company has a greater debt than equity, investor will assumed that the company has a high risk for example risk to fail in paying off their debt. This statement appropriate with a research by Azizi et al. (2015). The research explains that financial leverage has significant relationship with earnings response coefficient.

### Earnings Response Coefficient (ERC)

ERC captures the return sensitivity to the earnings surprises. These surprises are measured by the unexpected earnings defined as the difference between realized and forecasted earnings. In other words, ERC represents the market reaction, in terms of price change, corresponding to an unit of unexpected earnings (Mahjoubi & Abaoub, 2015).

A study about Earnings Response Coefficient had been conducted by Hasanzade et al. (2013). The research uses five independent variables: earnings quality, financial leverage, growth opportunity, profitability and systematic risk. From independent variables that have been tested, financial leverage doesn't give significant affect to Earnings Response Coefficient. Other research about Earnings Response Coefficient also conducted by Mashayekhi and Aghel (2016). The research uses firm size, earnings growth and earnings persistence as independent variables. The result of the research explains that earnings persistence has no significant effect to Earnings Response Coefficient. Mashayekhi and Aghel (2016) explain that while company publish their good news, investors will give positive reaction.

The dependent variable in this study is the earning response coefficient which was tested based on the market response to the unexpected parts of profit coefficient and the market response to the profit changes coefficient models. Earning Response Coefficient show market response to earnings information that published by company and can be observed from stock price movement around publication date (Diantimala, 2008). According to research that conducted by Mahjoubi and Abaoub (2015) explain that the ERC can be used as an indicator of earnings validity as a proxy for market expectations with regard to future security revenues.

### Company Size

According to the research that conducted by Arfan and Antasari (2008) explain that the bigger company will be center of attention than small company despite the company involve more many stakeholder also the effect that

generated by company is large and huge. The big size company can produce higher profit and larger to develop their business ability. The big size company also have good intern controlling system and professional human resource. According to research that conducted by Kusumawardhani and Nugroho (2010) explain that big company will publish more information than small company that can be used by investor to make economics decision.

### **Company's Growth**

For economics decision, investor often consider company ability in produce earnings continually. If company's earnings increase more and more each year, it shows that the company potentially obtain profit in future. Decreasing on profit show that the company has bad performance (Susanto, 2012). According to research that conducted by Arfan and Antasari (2008) explain that if company has a great company's growth will be able to finish their projects. Other research that testing relationship between company's growth and earnings response coefficient has been conducted by Azizi et al. (2015), Hasanzade et al. (2013), and Naimah and Utama (2006).

### **Profitability**

Profitability is a company ability to produce earnings as an effort for increase stockholder value (Kusumawardhani & Nugroho, 2010). Formula of profitability can use ROA (Return on Asset) or ROE (Return on Equity). ROA means company's effectiveness in produce earnings by exploit their asset (Kusumawardhani & Nugroho, 2010). ROE to measure company's ability in produce earnings by their equity (Arfan & Antasari, 2008).

### **Financial Leverage**

Debt-to-total-Assets Ratio (DAR) used as a proxy to calculate financial leverage. This ratio show percentage of assets that is fund by debt, the greater debt will show that company have higher risk (Horne & Wachowicz, 2008). When the company has a greater debt than equity, investor will assumed that the company has a high risk for example risk to fail their debt. The higher earnings that obtained from company that have a higher debt will give negative relationship because investor will assume that the profit for debtholders (Susanto, 2012).

### **Hypothesis development**

Company size is signal that given by the company. A bigger company will earn more trust on running their business and pay off their debts compared to a small company. This statement appropriate with the research by Mashayekhi and Aghel (2016). The research explain that company's size has significant relationship toward earnings response coefficient. Other research that appropriate with the result is Naimah and Utama (2006) research that conclude company's size has significant relationship toward earnings response coefficient. Based on the signaling theory that shown above, hypothesis can be drawn as follows:

H<sub>1</sub>: Company size has positive effect toward earnings response coefficient.

Company's growth is a signal issued by the company through financial report.the higher growth shown by a company, the better it attracts investor to invest their capital towards the company. Investor will assume that the company will grow bigger and give the investor a higher dividend annually. Company's growth predicted have positive effect to earnings response coefficient, company with higher growth will have higher earnings response coefficient (Setiawati & Nursiam, 2014).

The statement appropriate with research that conducted by Hasanzade et al. (2013). The research explain that company's growth has significant relationship toward earnings response coefficient.

H<sub>2</sub>: Company's growth has positive effect toward earnings response coefficient.

Profitability is also a signal given by the company. The company that successfully increased their profit indicates that the company has a good performance. So the company that has a higher profit will attract investor and increases earning response coefficient. This statement appropriate with research that conducted by Kusumawardhani and Nugroho (2010). The research explains that profitability has significant relationship towards earnings response coefficient. Based on that statement the hypothesis can be drawn as follows:

H<sub>3</sub>: Profitability has positive effect toward earnings response coefficient.

Based on research conducted by Santoso (2015) a company with higher liability concluded as a company with bad financial condition. When the company has a greater debt than equity, investor will assumed that the company has a high risk for example risk to fail their debt. This statement appropriate with research that

conducted by Azizi et al. (2015). The research explains that financial leverage has significant relationship with earnings response coefficient.

H4: Financial leverage has negative effect toward earnings response coefficient.

**Research Model**

Based on hypothesis development, researcher would like to test independent variable that affect Earnings Response Coefficient.

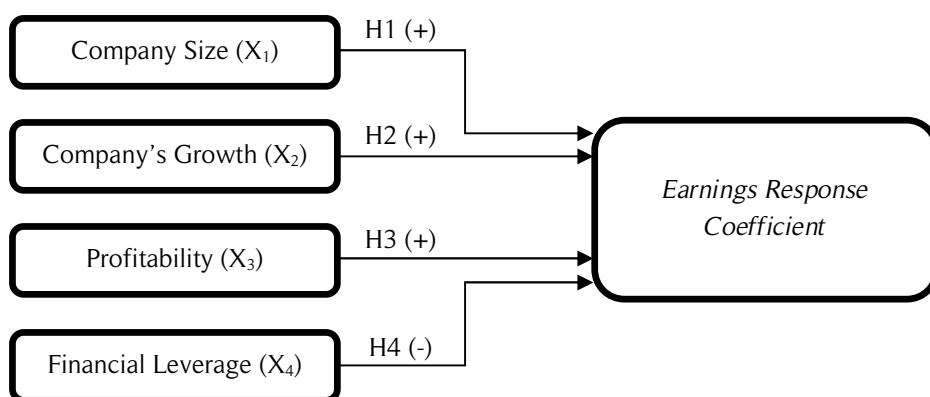


Figure 1. Research Model

**Research Method**

**Population and Sample**

This research uses quantitative approach. The population in this research are all manufacturing company that listed on the Indonesia Stock Exchange from 2013 to 2015 with purposive sampling technique. The sample selection criteria are as follows: 1). Manufacturing companies listed on the IDX for the period 2013-2015. 2). Manufacturing companies whose financial reports are complete during the study period. 3). Manufacturing companies that does not lose. 4). Manufacturing companies that have daily stock data and complete daily Composite Stock Price Index during the study period. 5). Manufacturing companies that have financial statement in rupiah. 6). Manufacturing companies that present publication date on the IDX website. Table 1 showed the result from samples.

Table 1. Research Sample

No	Criteria	Total
1	All manufactures company listed Indonesia Stock Exchange for period 2013-2015	125
2	Company that not provides a complete financial statement	(5)
3	Company that being loss for years 2013-2015	(40)
4	Manufactures company that have no complete data about daily stock price and daily IHSG	(3)
5	Manufactures company didn't report financial statement in IDR	(20)
6	There's no publication date in financial statement	(2)
Total manufactures company selected as sample		55
Total sample during three years		165

**Operational Variables**

This research consist four (4) independent variables that are company size, company's growth, profitability, financial leverage and consist from a variable dependent that is earnings response coefficient. Earnings response coefficient means response market towards earnings information that published by company. Earnings response coefficient is a coefficient that measures response security abnormal return toward company's unexpected accounting earnings (Arfan & Antasari, 2008). Earnings response coefficient can measured in two steps, first measure the cumulative abnormal return (CAR) for each sample and second step is measure the unexpected

earnings (UE) for each sample. Formula to calculate the earnings response coefficient as follows (Setiawati & Nursiam, 2014):

**Calculation of CAR of each sample.**

Calculate individual and market return

$$R_{it} = \frac{P_t - P_{t-1}}{P_{t-1}} \dots\dots\dots(1)$$

$$R_{mt} = \frac{IDX\ Composite_t - IDX\ Composite_{t-1}}{IDX\ Composite_{t-1}} \dots\dots\dots(2)$$

Note :

- R<sub>it</sub> = Individual return at (t) day
- P<sub>t</sub> = stock price company i at (t) day
- P<sub>t-1</sub> = stock price company i at (t) day
- R<sub>mt</sub> = market return at (t) day
- IDX Composite<sub>t</sub> = IDX Composite at (t) day
- IDX Composite<sub>t-1</sub> = IDX Composite at (t-1) day

Calculation of abnormal return

$$AR_{it} = R_{it} - R_{mt} \dots\dots\dots(3)$$

- AR<sub>it</sub> = Abnormal Return company at (t) day
- R<sub>it</sub> = Individual return at day
- R<sub>mt</sub> = Market return

Calculation of CAR

CAR is measured by short event windows during seven days (three days before published, on the day published, 3 days after published). CAR is calculated as follows Arfan and Antasari (2008):

$$CAR_{it} = CAR_{(-3,+3)} = \sum_{-3}^{+3} AR_{it} \dots\dots\dots(4)$$

Note:

- CAR<sub>it</sub> = Cumulative Abnormal Return company i at (t) year
- AR<sub>it</sub> = Abnormal Return company i at (t) da

Calculation of unexpected earnings of each sample

Unexpected earnings is proxy of accounting earning that explain company internal performance (Rahayu & Suaryana, 2015). Unexpected earnings can be measured by formula as follows:

$$UE_{it} = \frac{E_t - E_{t-1}}{|E_{t-1}|} \dots\dots\dots(5)$$

- UE<sub>it</sub> = Unexpected Earnings company i at (t) year
- E<sub>it</sub> = earnings after tax company i at (t) year
- E<sub>it-1</sub> = earnings after tax company i before at (t) year

Calculation of Earnings Response Coefficient of each sample

Earnings response coefficient is a coefficient obtained from simple regression between UE and CAR. In this research, regression between UE and CAR tested to obtain constant value each year. The constant value used for measuring ERC of each sample. In regression between UE and CAR, UE as an independent variable and CAR as dependent variable. Calculate earnings response coefficient as follows:

$$CAR_{it} = \beta_0 + \beta_1 UE_{it} + \epsilon_{it} \dots\dots\dots(6)$$

- CAR<sub>it</sub> = cumulative abnormal return company i at (t) year
- B<sub>0</sub> = Constant value

$B_1$  = Earnings Response Coefficient company i at (t) year  
 $UE_{it}$  = Unexpected Earnings company i at (t) year  
 $\epsilon_{it}$  = Error term.

Company size in this research measured by natural logarithm of total asset. This proxy according to research that conducted by (Arfan & Antasari, 2008). Formulae to calculate this variable as follows:

$$\text{Company's Size} = \ln TA_{it} \dots\dots\dots(7)$$

Note:

$\ln$  = Natural Logarithm  
 $TA_{it}$  = Total Asset, company i period at (t) year

Delta sale used as proxy to measure the company's growth. Company's growth more approximate for manufacturing company (Arfan & Antasari, 2008):

$$SG_{it} = \frac{S_{it}-S_{it-1}}{S_{it-1}} \times 100\% \dots\dots\dots(8)$$

$SG_{it}$  = Sales Growth company i at (t) year  
 $S_{it}$  = sale revenue company i at (t) year  
 $S_{it-1}$  = sale revenue company i at t-1 year

Profitability is a company ability to obtain earnings during a period. In this research, ROE (Return On Equity) used as proxy to measure profitability (Santoso, 2015).

$$ROE = \frac{\text{Net profit after tax}}{\text{equity}} \dots\dots\dots(9)$$

Debt-to-Total-Assets Ratio is a comparison between liability and total asset. This ratio determines percentage of company's assets funded by liability (Azizi et al., 2015).

$$DAR = \frac{\text{Total Liabilities}}{\text{Total Assets}} \dots\dots\dots(10)$$

**Result and Discussion**

According to the research, testing hypotheses conducted by multiple regression analysis that used to show relationship between company's size, company's growth, profitability, financial leverage toward earnings response coefficient. Earnings response coefficient is a coefficient obtained from simple regression between UE and CAR. In this research, regression between UE and CAR tested to obtain constant value each year. The constant value used for measuring ERC each sample. In regression between UE and CAR, UE as an independent variable and CAR as dependent variable and the result of simple regression as follows:

CAR 2013 = -0,020 - 0,004  $UE_{2013}$   
 CAR 2014 = -0,002 + 0,009  $UE_{2014}$   
 CAR 2015 = 0,000 -0,002  $UE_{2015}$

From the result of simple regression above, then can calculated earnings response coefficient as follow:

$$CAR_{it} = \beta_0 + \beta_1 UE_{it} + \epsilon_{it} \dots\dots\dots(10)$$

**Descriptive Analysis**

Descriptive analysis used to represent or describe research's variables. Formula to describe are average value, maximum value, minimum value and standard deviation.

Based on Table 2, the average of ERC is 0,003086. ERC's maximum value is 1,9345. The minimum value of ERC is -5,2383. Standard deviation of ERC is 0,6092847, this amount higher than average value, it means that the spreading of ERC in manufacturing company that listed in BEI is heterogeneous. The average of company's size (SIZE) is 28,262950. The maximum value of SIZE at 33,1341. The average of financial leverage (LEV) is 0,156764. The maximum value of LEV is 20,1583 reached. The amount higher than average value, it means that the data is heterogeneous.

**Table 2.** Descriptive Statistic

	N	Minimum	Maximum	Mean	Std. Deviation
ERC	165	-5.2383	1.9345	-.003086	.6092847
SIZE	165	25.3919	33.1341	28.262950	1.6785415
GROWTH	165	-.2990	1.2731	.099345	.1938039
PROF	165	.0010	1.4353	.156701	.1824292
LEV	165	.0002	20.1583	.516764	1.5509479
Valid N (listwise)	165				

### The result of hypothesis test

This research use smartPLS as tool analysis. The validity of the hypothesis can be seen from the P-value (Ghozali & Latan, 2015). If P-value < 0,05, it means that independent variable has significant relationship toward dependent variable. If P-value > 0,05, it means that variable has no significant relationship toward dependent variable. The original sample explain that the research has positive or negative influence.

**Table 3.** Path Coefficient

	Original Sample (O)	Sample Mean (M)	Standard Deviation (STDEV)	T Statistics (IO/STDEVI)	P Values
Financial Leverage -> ERC	-0.027	-0.051	0.055	0.492	0.623
Company's Growth -> ERC	0.138	0.157	0.055	2.484	0.013
Profitability -> ERC	-0.039	-0.043	0.057	0.680	0.497
Company's Size -> ERC	-0.012	0.004	0.087	0.132	0.895

Following the table path coefficient can concluded that company's growth (X2) have positive effect toward earnings response coefficient (Y) with p-value 0.013 and original sample positive 0.138. Meanwhile, company's size (X1), Profitability (X3), and financial leverage (X4) have no significant effect toward earnings response coefficient (Y) because of P-value more than 0.05. According to this research, can be concluded that hypothesis 2 (H2) is accepted but hypothesis 1 (H1), hypothesis 3 (H3) and hypothesis 4 (H4) are rejected.

### Discussion

Signaling theory explain that information is an important element for investors and other stakeholders because information provides explanation about the past condition, nowadays and future condition for company viability and the impact to company (Rahayu & Suaryana, 2015). According to this research, company's growth has positive effect towards earnings response coefficient, but company size, profitability and financial leverage don't give significant effect towards earnings response coefficient.

The result of this research prove that company's growth has positive effect toward earnings response coefficient. The result appropriate with signal theory. Signal theory explains that if the company has a great growth, it will attract investor to invest their capital to the company. Investor will assumed that company will grow bigger and give the investor a higher dividend annually. A higher company's growth also show that the company has good performance, so investor attracted with company with higher company's growth (Susanto, 2012). This result appropriate with research that conducted by Arfan and Antasari (2008).

The company's size in this research was be obtained by natural logarithm of the total assets. Total assets composed from two source fund that is liability and equity. When liability higher than equity, investors will assess that company has high risk. Therefore, the result of this research is company size has not effect toward earnings response coefficient. These result is not in line with research conducted by Arfan and Antasari (2008), which shows a negative influence between company size variables and ERC and the research conducted by Rahayu and Suaryana (2015) which states that company size has a positive effect on earnings response coefficient. The results of this study are not in accordance with the signal theory which states that company size is a signal issued by a company that can affect earnings response coefficient. Investors may not only see the size of the company based on total assets, but can be with the amount of income earned or the number of workers in the company.

Profitability is company's ability to get profit to rise up stockholder's value (Kusumawardhani & Nugroho, 2010). Therefore, the higher profitability will attract investors to be of the stockholders in the company.

The result of this research prove that profitability has not effect toward earnings response coefficient. The reason of the result because investor's consideration to be stockholder in the company not only observe return on equity in a year but also observe the stability of profitability several year before as a consideration. Unstability of profitability will give negative effect between profitability and earnings response coefficient. According to research that conducted by Santoso, (2015), Indonesian investors still influenced by psychology factor in taking investment decision and lack of consideration in fundamental aspect like use financial statement in making decision. The results of this study are in line with research conducted by Arfan and Antasari (2008) which states that profitability does not have significant positive effect on earnings response coefficient. This result is contrary to research conducted by Kusumawardhani and Nugroho (2010) and Naimah and Utama (2006), which states that profitability has a significant significant effect on earnings response coefficient.

The results of this study indicate that financial leverage has no effect on earnings response coefficient. This is consistent with the signal theory which states that when a company has a debt level that is greater than its equity, investors will see a risk that the company cannot fulfill its obligations. This resulted in investor response to the company is small. The result of this study is in line with research conducted by Hasanzade et al. (2013) which states that financial leverage has no significant effect on earnings response coefficient. This contrasts with research conducted by Azizi et al. (2015) which states that financial leverage has a significant effect on earnings response coefficient. The research that conducted by Santoso (2015), explain that financial leverage have no significant relationship toward earnings response coefficient because Indonesian investors more interested with market capital fluctuation than profit information and Indonesian investor just consider the profit that may accepted. Therefore, risk of the debt in the company unconsidered in making decision.

## Conclusion

Based on the research that has been done regarding the determinants that affect earnings response coefficient on manufacturing companies listed in Indonesia Stock Exchange during 2013-2015, then it can be concluded as follows: 1). The results shows that company's growth has a positive effect on the earnings response coefficient. This study indicates that high growth companies will give a good signal to investors. 2). The company size, profitability and financial leverage do not have any effect on the earnings response coefficient

Based on this research, the limitation of this research as follows: 1). This research just test of the factors that affect earnings response coefficient in Indonesia. 2). This research just test four independent variables. 3). This research just prove the influence of factors that affect earnings response coefficient in Indonesia. The suggestion for next research is: 1). Next research suggested to test factors that affect earnings response coefficient in other ASEAN country. 2). This research just test four variable independent, for next research suggested to test other independent variable. For example CSR, Earnings Persistence and earnings quality. 3). Maybe in the next research can be compared between the factors that affect ERC in Indonesia and the factors that affect ERC in Malaysia.

The implication from this research is to give information to investors about accounting information that can be used to make economics decision. This study illustrates that high growth companies will give a good signal to investors.

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